1988

Amax Magnesium Corp. v. Utah State Tax Commission : Brief of Amicus Curiae

Utah Supreme Court

Original Brief Submitted to the Utah Supreme Court; digitized by the Howard W. Hunter Law Library, J. Reuben Clark Law School, Brigham Young University, Provo, Utah; machine-generated OCR, may contain errors.
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IN THE SUPREME COURT

STATE OF UTAH

AMAX MAGNESIUM CORPORATION, Petitioner/Plaintiff	:	Civil No. 88-0251
-vs-	:	
THE UTAH STATE TAX COMMISSION, Respondent/Defendant.	:	Priority 14a

BRIEF OF AMICUS CURIAE

UTAH ASSOCIATION OF COUNTIES

ON APPEAL FROM THE UTAH STATE TAX COMMISSION

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JURISDICTION

This Court has jurisdiction of this action pursuant to Utah Code Annotated Section 78-2-2(3)(e)(ii)(1988), Utah Code Annotated Section 59-1-602(3)(1987)(a now repealed part of the Tax Court Act), and Rule 14 of the Rules of the Utah Supreme Court.

STATEMENT OF ISSUE PRESENTED FOR REVIEW

Does Utah Code Annotated, Section 59-5-4.5 violate the equal protection and due process clauses of Article 13, Section 3 and Article 1, Section 25, of the Utah Constitution, and the due process and equal protection clauses of the Constitution of the United States of America.

CONSTITUTIONAL PROVISIONS AND STATUTES

Article XIII, Section 3(1), of the Utah Constitution, see Addendum I;

Article I, Section 24, of the Utah Constitution, see Addendum I;

14th Amendment of the United States Constitution, see Addendum I;

Utah Code Annotated Section 59-5-3(1986), see Addendum I;

Utah Code Annotated Section 59-5-4.5(1), Supp.. 1986; see Addendum I;

49 U.S.C. Section 11501(b)(1), see Addendum I.

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RELIEF SOUGHT ON APPEAL

The Utah Association of Counties ("U.A.C.") seeks affirmance of the decision of the Utah State Tax Commission and a determination that Utah Code Annotated Section 59-5-4.5 is constitutional in all respects.

STATEMENT OF THE CASE

I. NATURF OF PROCEEDINGS

U.A.C. agrees with the statement of the case set forth in the brief of Respondent/Defendant, Utah State Tax Commission.

In this appeal, AMAX seeks review of the Utah State Tax Commission's final decision concerning the 1986 assessed value of AMAX's tangible real and personal property located in Tooele County, Utah. AMAX's property was assessed as of January 1, 1986, at $84,332,150. After an informal hearing, said valuation was reduced to $78,312,895. (TR-586-592) The Tax Commission thereafter held a plenary formal hearing to determine the fair market value of AMAX's property. On December 21, 1987, the Tax Commission issued a final decision further reducing the assessed value of AMAX property by approximately $6,000,000, based upon the Commission's finding that dike maintenance should have been expensed rather than included as a capital investment. The Tax Commission affirmed all other aspects of the Property Tax Division's assessment. (TR-333-338). AMAX thereafter filed a petition for reconsideration, which the Tax Commission denied by order dated May 31, 1988. (TR-334) AMAX then filed a Petition for Review with this Court on June 29, 1988.

II. STATEMENT OF FACTS

In determining the taxable value of AMAX's property for tax year 1986, the Tax Commission rejected the request by AMAX to apply Section 59-5-4.5 to its centrally assessed property. In its Findings of Fact, Conclusions of Law and Final Decision, the Tax Commission concluded that Section 59-5-4.5 "does not apply to property which is centrally assessed, such as the subject property." The Tax Commission concluded that AMAX's property is centrally assessed under the provisions of the Utah Code and that 59-5-4.5 does not extend the deduction to centrally assessed properties. Further, the Tax Commission concluded that non-application of 59-5-4.5 to AMAX's centrally assessed property is not unconstitutional.

The Tax Commission based its conclusion on the case of Rio Algom Mining Corporation v. San Juan County, et al. 681 P.2d 184 (Utah 1984), (TR-366). The U.A.C. agrees with the statement of facts as set forth in the brief of Respondent/Defendant, Utah State Tax Commission.

SUMMARY OF ARGUMENTS

U.A.C. asserts that the decision of the Utah Supreme Court in the case of Rio Algom Mining Corporation v. San Juan County fully and adequately addressed the question of the constitutionality of Section 59-5-4.5. U.A.C. further asserts that the decision issued by the Honorable Bruce S. Jenkins, United States District Court Judge, interpreting the 4-R Act enacted by Congress as it applied to railroad transportation property, does not, and should not impact the validity of Section 59-5-4.5. Further, U.A.C. that the recent decision of the United States Supreme Court in the case of Allegheny Coal v. Webster County, does not impact the statutory scheme for taxing centrally and locally assessed properties within the State of Utah, because the Utah statutory scheme does not discriminate between comparable properties. The Utah statutes provide for sales assessment ratio studies, and, in fact, seasonably adjust all locally assessed properties every other year to reflect the impact of sales in the market place.

ARGUMENT

UTAH CODE ANNOTATED, SECTION 59-5-4.5, IS CONSTITUTIONAL IN ALL RESPECTS AND DOES NOT VIOLATE THE PRINCIPLES OF UNIFORMITY, DUE PROCESS OR EQUAL PROTECTION GUARANTEED BY THE CONSTITUTION OF UTAH AND THE UNITED STATES.

POINT I

THE DECISION OF THE UTAH SUPREME COURT IN RIO ALGOM MINING CORP. V. SAN JUAN COUNTY IS CONTROLLING.

In Rio Algom Corp. v. San Juan County, 681 P.2d 184 (Utah 1984), this Court upheld the constitutionality of Utah Code Annotated Section 59-5-4.5 against an equal protection challenge brought by centrally assessed property owners who claimed the statute was unconstitutional as applied to them.

This Court, speaking through Justice Stewart, determined that the Legislature acted neither unconstitutionally nor unreasonably in addressing the problem of the growing disparity of the tax burden that was being assumed by locally assessed properties as compared to the burden imposed upon centrally (state) assessed properties. The statute challenged in Rio Algom was the same statute challenged in this case.

The Plaintiffs in Rio Algom argued that the allowance of a 20% reduction from the comparable sale appraisal or cost appraisal was in conflict with Article XIII, Section 2 of the Utah Constitution, which required that all tangible property "shall be taxed in proportion to its value" and Section 3 which required that property be valued "according to its value in money."

In addressing the constitutional question the Court through Justice Stewart, opined:

> An analysis of the constitutionality of §59-5-4.5 must begin with the proposition that acts of the Legislature are presumed constitutional, especially when dealing with economic matters based on factual assumptions." Baker v. Matheson, Utah, 607 P.2d 233 (1979); Salt Lake City v. Tax Commission, 11 Utah 2d 359, 359 P.2d 397 (1961). A party attacking the constitutionality of the statute must affirmatively demonstrate its unconstitutionality. E.G., Stone v. Department of Registration, Utah 567 P.2d 1115 (1977); Salt Lake City v. Tax Commission, supra; Thomas v. Daughters of Utah Pioneers, 114 Utah 108, 197 P.2d 477 (1948).
>
> The presumption of constitutionality applies with particular force to tax statutes. Although we are concerned here with the

constitutionality of §59-5-4.5 under Article XIII of the Utah Constitution, what has been stated by the United States Supreme Court with respect to tax statutes challenged under the Equal Protection Clause of the Fourteenth Amendment is relevant to the instant problem. In San Antonio School District v. Rodriguez, 411 U.S. 1, 40, 93 S.Ct. 1278, 1300, 36 L.Ed.2d 16 (1973), the Court stated:

> No scheme of taxation, whether the tax is imposed on property, income, or purchases of goods and services, has yet been devised which is free of all discriminatory impact. In such a complex arena in which no perfect alternatives exist, the Court does well not to impose too rigorous a standard of scrutiny lest all local fiscal schemes become subjects of criticism under the Equal Protection Clause." [Footnote omitted.]

See also Madden v. Kentucky, 309 U.S. 83, 60 S.Ct. 406, 84 L.Ed. 590 (1940); New York Rapid Transit Corp. V. New York, 303 U.S. 573, 58 S.Ct. 721, 82 L.Ed. 1024 (1938).

681 P.2d at 190-191.

The Court recognized that different methodologies were necessary in order to assess different kinds of property which could result in an unavoidable, de facto classification. This de facto classification resulted from the use of the various valuation formulae used to estimate market value. The Court further reasoned that "market value" as a means of achieving uniformity was an imprecise tool and that Section 3 of Article XIII conferred upon the Legislature the authority and power to provide by law for just valuations. The Court stated:

> Accordingly, when dealing with assessments of classes of property, Section 3 must be read to

> permit a necessary latitude in defining 'market value.'
>
> The point was made even more clearly in Court in United States Smelting, Refining and Mining, Co. v. Haynes, 176 P.2d 622, 627 (Utah 1947) where the Court stated:
>
>> It will be observed that these provisions [§§2 and 3 of Article XIII] require that all tangible property ... shall be subjected to a uniform and equal rate of assessment according to its value in money. The method or yardstick by which the valuation in money is to be determined shall be prescribed by the legislature. It is not required that the same yardstick or method of determining value shall be used with respect to all kinds of property. But the different formulae which may be applied to different kinds of property must be such that they aim and tend to secure for assessment purposes a valuation fair and equitable in comparison with and commensurate with the valuation of other kinds of property. When the valuation thus secured is such that if the uniform and equal rate of taxation is applied to the valuation the property is taxed in the same proportion to its value as is all other tangible property, the method of arriving at the assessed valuation is not subject to constitutional objections as violative of our Article XIII. (Emphasis supplied.)

681 P.2d at 191.

AMAX and the Utah Mining Association argue that this case is different than Rio Algom because in that case there was no evidence of actual non-uniformity in tax assessments of state assessed properties as compared with county assessed properties. However, U.A.C. has been unable to locate any such evidence in this case. The basis for that assertion by AMAX and the Mining Association appears to rest upon the question of whether or not AMAX's property is "appurtenant" to a mine and the decision of the United State District Court in Union Pacific Railroad, et al., v. Utah State Tax Commission, No. C82-0998J, slip. op. (D. Utah, 1988). However, as this Court pointed out in Rio Algom, Plaintiffs must prove that their own properties are assessed at market value; that they bear a tax burden greater than their pro-rata share of the property taxes in Tooele County; that the deduction of transactional "intangible" costs from comparable sales figures or estimates of cost as permitted by Section 59-5-4.5 defeats the constitutional objective of establishing a valuation that is fair and equitable in comparison with and commensurate with the valuation of other kinds of property.

In summary, AMAX has failed to prove factually that Section 59-5-4.5 is not consistent with the constitutional requirement that properties be valued at market value. AMAX's property is a special purpose property. It is not comparable to any other property located within Tooele County and assessed by the County Assessor. Its market value is not readily determinable by the existence of an actual market. To attempt to compare it to other locally assessed properties such as a house, a farm, an industrial property or some other similar property that does not have a fixed special purpose, is pure speculation. Speculation, rather than evidence, should not be the basis upon which a determination made by the Legislature be over-turned. Nor, should a decision interpreting a specific federal statute relating to the assessment of railroads be a basis for invalidating an act of the Legislature. Judge Jenkins was very careful to narrowly limit his decision in the Union Pacific case. His interpretation of the 4-R Act as it applied to Utah railroads does not compel a determination that Section 59-5-4.5 is unconstitutional. The record does not disclose any evidence that could cause this Court to conclude that the transactional or intangible costs determined by the Legislature are factually abritrary. Nor does the record disclose any evidence that would dispute the Legislature's determination that a large shift in the tax burden had taken place and that the burden of taxation had been shifted away from state assessed properties and upon locally assessed properties. This determination and its implications were recognized by the Court in Rio Algom. And, as this Court observed:

> Even without the defendants' evidence, however, we would still be obliged to presume that there is a valid factual basis for the challenged statute. See Matter of McCannel, supra, 301 N.W.2d at 916; Elwell v. Hennepin County, 301 Minn. 63, 221 N.W. 2d 538 (1974).
>
> Certainly the Legislature may not establish formal classifications of property that result in nonuniform or disproportionate tax burdens. But the Legislature may seek to enforce the uniformity requirement of §3 by attempting to equalize the tax burden borne by those taxpayers who pay a greater tax in proportion to the value of their property than others. In permitting transaction costs to be deducted from appraisals based on comparable sales or cost appraisal method, the Legislature has neither departed from the "case value" requirement of Article XIII, §3, nor gone beyond its constitutional duty to "prescribe by law such regulations as shall secure a just valuation for taxation."

> Id, Clearly, the statute is not based on a plan or a principle designed to violate equality and uniformity. Denver v. Lewin, 106 Colo. 331, 105 P.2d 854 (1940).
>
> The overarching purpose of §§2 and 3 of Article XIII is to achieve uniformity in the ad valorem taxing scheme. The definition of value is one element in a formula designed to achieve that end by establishing a common denominator for valuation purposes. The law has long been that where "it is impossible to achieve both the standards of the true value, and the uniformity and equality required by law, the latter requirement is to be preferred as the just and ultimate purpose of the law. Delaware, Lackawanna & Western Railroad v. Neeld, 23 N.J. 561, 570, 130 A.2d 6, 11 (1957), quoting Sioux City Bridge Co. v. Dakota County, 260 U.S. 441, 43 S.Ct. 190 67 L.Ed. 340 (1923), (Emphasis supplied.)

681 P.2d 193-194.

This Court's decision and reasoning in Rio Algom in 1984 are no less applicable to the same law two years later in 1986. Nor is there any evidence to suggest or establish that the position of the Legislature has changed. Indeed, had its position changed, it would have amended or repealed Section 59-5-4.5. It did not. Justice Stewart's reasoning in 1984 is equally applicable today. He stated:

> Equal protection provisions of the federal and state constitutions accord particularly wide latitude to legislative classifications in tax statutes. Apache County v. Atchison, Topeka & Santa Fe Railway, 106 Ariz. 357, 476 P.2d 657 (1970). "No scheme of taxation, whether property, income or otherwise, "has yet been devised which is free of all discriminatory impact." San Antonio School District v. Rodriguez, J, 411 U.S. 1, 41, 93 S.Ct. 1278, 1301, 36 L.Ed.2d 16 (1973). In Nashville, Chattanooga & St. Louis Railway v. Browning, 310 U.S. 362, 368, 60 S.Ct.

968, 971, 84 L.Ed. 1254 (1940), the Supreme Court stated:

> This Court has previously had occasion to advert to the narrow and sometimes cramping provision of these state uniformity clauses, and has left no doubt that their inflexible restrictions upon the taxing powers of the state were not to be insinuated into that meritorious conception of equality which alone the Equal Protection Clause was designed to assure.

In sum, §59-5-4.5 does not violate the equal protection provisions of the state and federal constitutions.

681 P.2d 194.

POINT II

THE DECISION ISSUED BY THE UNITED STATES DISTRICT COURT IN THE UNION PACIFIC RAILROAD CASE INTERPRETS THE RAILROAD REVITALIZATION ACT (4-R ACT), AND DOES NOT ADDRESS THE QUESTION OF THE CONSTITUTIONALITY OF SECTION 59-5-4.5.

AMAX and the Utah Mining Association take great comfort in the decision issued by the Honorable Bruce S. Jenkins in Union Pacific Railroad, et al., v. Utah State Tax Commission, et al., C-82-0998J slip. op. (D. Utah, December, 1988). However, that reliance is totally misplaced. It is clear from the decision of Judge Jenkins that he was interpreting Section 306 of the 4-R Act, codified at 49 U.S.C. Section 11503, which prohibits states and local taxing authorities from discriminating against railroad property. That section makes it unlawful for a state to assess railroad transportation property at a value which bears a higher ratio to the true market value of such transportation property than the ratio which the assessed value of all other commercial and industrial property in the same assessment jurisdiction bears to the true market value of all such other commercial and industrial property. In its decision, the Court concluded that "for purposes of the 4 R Act, the true market value of 'all other commercial and industrial property' in the State of Utah must be determined before the 20 percent discount statute is applied." Id. at 56-56. The Court went on to say, at page 57:

> "This does not mean that the state cannot continue to give the 20 percent discount to locally assessed real property. It simply means that, in determining whether the state's assessments of railroads discriminates against the railroads in violation of the 4 R Act, the court must consider the value of locally assessed real property before the statutory discount is applied. The state may still be free to choose to tax real property on the basis of the net amount the property owner could expect to receive from the sale of his property."

The Court referenced this Court's decision in the Rio Algom case, and noted that Section 59-5-4.5 did not violate Article XIII of the Utah Constitution or the Equal Protection Provisions of either the State of general constitution. The Court stated:

> "The state's intent in passing the discount statute appears to have been to tax real property owners only on what they might expect to receive from the sale of their property, and not on a hypothetical sale. That intent may be admirable. Moreover, the statute may pass constitutional muster."

Id. at 54.

Because the federal court has interpreted a federal statute and applied that interpretation to a protected class, this Court is not required to afford similar treatment to other property owners who are not within the class protected by the federal law. To illustrate, the federal government has passed legislation known as the Federal Soldiers' and Sailor's Civil Relief Act. That statute provides that servicemen who are stationed in Utah do not acquire tax status for purposes of state personal property and income taxes. The fact that the federal government has enacted a statute to protect a specific class of persons, i.e., soldiers and sailors, does not mean that the State of Utah has to afford similar treatment to an executive of AMAX or Kennecott Copper, or some other executive who has been transferred from out of the state to Utah. Clearly, such a person would be subject to personal property and income taxation by the State of Utah. That person is not within the class of persons who were singled out for protection by Congress.

Similarly, AMAX, and other centrally assessed property owners in the State of Utah, with the exception of railroads, have not been given the benefit of the Congressional enactment, do not fit within the class of protected property owners identified in the 4-R Act, and can therefore not assert the benefit of the Court's interpretation of the 4-R Act in this case.

POINT III

THE UTAH MINING ASSOCIATION'S RELIANCE UPON THE UNITED STATES SUPREME COURT DECISION IN ALLEGHENY PITTSBURGH COAL COMPANY V. WEBSTER COUNTY WEST VIRGINIA, IS MISPLACED AND FAILS TO CORRECTLY INTERPRET THE IMPACT OF THAT DECISION.

In Allegheny Pittsburgh Coal Company v. Webster County West Virginia, 109 S.Ct. 633 (1989), the United States Supreme Court was called upon to determine the constitutionality of an assessment practice which assessed the petitioner's property eight to 35 times higher than "comparable" neighboring property, and that discrepancy continued for more than ten years. The Court, in Allegheny Coal, recognized that the equal protection clause of the United States Constitution does allow a state to divide different kinds of property into classes, and to assign to each a different tax burden so long as those divisions and burdens are neither arbitrary or capricious. The Court, however, pointed out that West Virginia had not drawn such a distinction, and the practice resulted in those disparities in the assessed value of generally comparable property. The lower Court had determined that the sole basis of the assessment of the petitioner's real estate was, according to the Assessor, the consideration declared on the property owner's deed. The Court found this approach to systematically produce dramatic differences in valuation between petitioner's recently transferred property, and otherwise comparable surrounding property. And, for the years 1976 through 1982, Allegheny was assessed and taxed as approximately 35 times the rate applied to owners of comparable properties. The Court recognized that seasonable adjustments could be made to eliminate the disparities that existed, but the adjustments that were being made by assessor to the Allegheny property was so nominal that it would require more than 500 years to equalize the assessment of Allegheny's property with other comparable, surrounding properties.

Finally, the Court concluded that intentional, systematic undervaluation by state officials of other taxable property in the same class contravenes the constitutional right of one taxed upon the full value of his property. Further, that the equal protection clause protects the individual from state action, which selects him out for discriminatory treatment by subjecting him to taxes not imposed on others of the same class.

Section 59-5-4.5 is a legislative recognition that, for purposes of determining fair market value, there are two classes of property. Those are properties assessed by the State Tax Commission, and those assessed by local county assessors. Within the class of state assessed properties, are different types of properties which require different appraisal methodology to arrive at the fair market value of the various types of properties assessed by the State of Utah. For example, in some instances historical cost less depreciation is the primary methodology utilized to determine taxable value. In other instances, it is capitalized income. In other instances it may be the ratio of stock to debt. The type of property within the class of state assessed properties determines which valuation tool will best reflect the fair market value of the property. To say that the cost approach is used does not mean that the cost approach used on a state assessed property is the same as the cost approach used on locally assessed property. See Addendum II for the guidelines that are currently in use by the Utah State Tax Commission in deriving cost indicator of value. Also, attached as Addendum II is an excerpt from the 1971 Western States Association of Tax Administrators Report of Committee on Railroad and Utility Valuation, which explains the different types of costs that are considered in determining the cost indicator of value. Similarly, there are different appraisal tools that are utilized by local county assessors to derive the fair market value of locally assessed properties. County assessors, in utilizing a cost approach to value as one of the components of a correlated value, look to replacement cost new, less depreciation. This is a significant difference from the historical cost less depreciation, or net book value, that is used to value a regulated utility by the state assessing authorities.

Attached as Addendum III are excerpts from the Property Assessment Valuation Guide issued by the International Association of Assessing Officers, and an excerpt from Appraising the Single Family Residence by Broom and Harrison, both of which demonstrate the cost approach employed by local assessors.

The statutory scheme for assessing centrally assessed properties and locally assessed properties in the State of Utah creates acceptable classes which do not violate equal protection as set forth by the United States Supreme Court in Allegheny Coal. Nor, can it be asserted that the statutory scheme for assessing state assessed properties and locally assessed properties results in an "intentional, systematic undervaluation which result in discriminatory tax treatment of a comparable class of property." Id. at 639.

The reliance of the Utah Mining Association on the case of Allegheny, is therefore misplaced.

CONCLUSION

It is respectfully submitted that this Court's decision in the case of Rio Algom Mining Corporation completely addressed the question of the constitutionality of Utah Code Annotated Section 59-5-4.5. The reasoning employed by this Court in the Rio Algom case is consistent with the reasoning applied by the United States Supreme Court in the case of Allegheny Coal. Further, the decision of the United States District Court interpreting the 4-R Act was specifically limited by Judge Bruce Jenkins to an interpretation of the 4-R Act, and did not address the question of the constitutionality of Section 59-5-4.5. The decision of the State Tax Commission should be affirmed.

RESPECTFULLY SUBMITTED this 29th day of November, 1989.

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I do hereby certify that four copies of the foregoing brief were served by hand-delivery, on the 29th day of November, 1989, upon the following persons:

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ADDENDUM I

rate in proportion to its value, to be ascertained as provided by law.

(2) The following are property tax exemptions.

(a) The property of the state, school districts, and public libraries;

(b) The property of counties, cities, towns, special districts, and all other political subdivisions of the state, except that to the extent and in the manner provided by the Legislature the property of a county, city, town, special district or other political subdivision of the state located outside of its geographic boundaries as defined by law may be subject to the ad valorem property tax.

(c) Property owned by a nonprofit entity which is used exclusively for religious, charitable or educational purposes;

(d) Places of burial not held or used for private or corporate benefit; and

(e) Farm equipment and farm machinery as defined by statute. This exemption shall be implemented over a period of time as provided by statute.

(3) Tangible personal property present in Utah on January 1, m., which is held for sale or processing and which is shipped to final destination outside this state within twelve months may be deemed by law to have acquired no situs in Utah for purposes of ad valorem property taxation and may be exempted by law from such taxation, whether manufactured, processed or produced or otherwise originating within or without the state.

(4) Tangible personal property present in Utah on January 1, m., held for sale in the ordinary course of business and which constitutes the inventory of any retailer, or wholesaler or manufacturer or farmer, or livestock raiser may be deemed for purposes of ad valorem property taxation to be exempted

(5) Water rights, ditches, canals, reservoirs, power plants, pumping plants, transmission lines, pipes and flumes owned and used by individuals or corporations for irrigating land within the state owned by such individuals or corporations, or the individual members thereof, shall be exempted from taxation to the extent that they shall be owned and used for such purposes.

(6) Power plants, power transmission lines and other property used for generating and delivering electrical power, a portion of which is used for furnishing power for pumping water for irrigation purposes on lands in the state of Utah, may be exempted from taxation to the extent that such property is used for such purposes. These exemptions shall accrue to the benefit of the users of water so pumped under such regulations as the Legislature may prescribe

(7) The taxes of the poor may be remitted or abated at such times and in such manner as may be provided by law

(8) The Legislature may provide by law for the exemption from taxation: of not to exceed 45% of the fair market value of residential property as defined by law; and all household furnishings, furniture, and equipment used exclusively by the owner thereof at his place of abode in maintaining a home for himself and family.

(9) Property owned by disabled persons who served in any war in the military service of the United States or of the state of Utah and by the unmarried widows and minor orphans of such disabled persons or of persons who while serving in the military service of the United States or the state of Utah were killed in action or died as a result of such service may be exempted as the Legislature may provide

(10) Intangible property may be exempted from taxation as property or it may be taxed as property in such manner and to such extent as the Legislature may provide, but if taxed as property the income therefrom shall not also be taxed. Provided that if intangible property is taxed as property the rate thereof shall not exceed five mills on each dollar of valuation.

(11) The Legislature shall provide by law for an annual tax sufficient, with other sources of revenue, to defray the estimated ordinary expenses of the state for each fiscal year. For the purpose of paying the state debt, if any there be, the Legislature shall provide for levying a tax annually, sufficient to pay the annual interest and to pay the principal of such debt, within twenty years from the final passage of the law creating the debt. 1987

Sec. 3. [Assessment and taxation of tangible property — Livestock — Land used for agricultural purposes.]

(1) The Legislature shall provide by law a uniform and equal rate of assessment on all tangible property in the state, according to its value in money, except as otherwise provided in Section 2 of this Article. The Legislature shall prescribe by law such provisions as shall secure a just valuation for taxation of such property, so that every person and corporation shall pay a tax in proportion to the value of his, her, or its tangible property, provided that the Legislature may determine the manner and extent of taxing livestock

(2) Land used for agricultural purposes may, as the Legislature prescribes, be assessed according to its value for agricultural use without regard to the value it may have for other purposes. 1982

Sec. 4. [Mines and claims to be assessed — Basis and multiple — What to be assessed as tangible property.]

All metalliferous mines or mining claims, both placer and rock in place, shall be assessed as the Legislature shall provide, but the basis and multiple now used in determining the value of metalliferous mines for taxation purposes and the additional assessed value of $5 00 per acre thereof shall not be changed before January 1, 1935, nor thereafter until otherwise ~~provided by law~~ All ~~other mines or~~ mining claims and other valuable mineral deposits, including lands containing coal or hydrocarbons and all machinery used in mining and all property or surface improvements upon or appurtenant to mines or mining claims, and the value of any surface use made of mining claims, or mining property for other than mining purposes, shall be assessed as other tangible property 1982

Sec. 5. [Local authorities to levy local taxes — Sharing tax and revenues by political subdivisions.]

The Legislature shall not impose taxes for the purpose of any county, city, town or other municipal corporation, but may, by law, vest in the corporate authorities thereof, respectively, the power to assess and collect taxes for all purposes of such corporation Notwithstanding anything to the contrary contained in this Constitution, political subdivisions may share their tax and other revenues with other political subdivisions as provided by statute 1982

Sec. 6. [Annual statement to be published.]

An accurate statement of the receipts and expenditures of the public moneys, shall be published annu-

Sec. 22. [Private property for public use.]
Private property shall not be taken or damaged for public use without just compensation. 1896

Sec. 23. [Irrevocable franchises forbidden.]
No law shall be passed granting irrevocably any franchise, privilege or immunity. 1896

Sec. 24. [Uniform operation of laws.]
All laws of a general nature shall have uniform operation. 1896

Sec. 25. [Rights retained by people.]
This enumeration of rights shall not be construed to impair or deny others retained by the people. 1896

Sec. 26. [Provisions mandatory and prohibitory.]
The provisions of this Constitution are mandatory and prohibitory, unless by express words they are declared to be otherwise. 1896

Sec. 27. [Fundamental rights.]
Frequent recurrence to fundamental principles is essential to the security of individual rights and the perpetuity of free government. 1896

ARTICLE II

STATE BOUNDARIES

Section
1. [State boundaries.]

Section 1. [State boundaries.]
The boundaries of the State of Utah shall be as follows:

Beginning at a point formed by the intersection of the thirty-second degree of longitude west from Washington, with the thirty-seventh degree of north latitude; thence due west along said thirty-seventh degree of north latitude to the intersection of the same with the thirty-seventh degree of longitude west from Washington; thence due north along said thirty-seventh degree of west longitude to the intersection of the same with the forty-second degree of north latitude; thence due east along said forty-second degree of north latitude to the intersection of the same with the thirty-fourth degree of longitude west from Washington; thence due south along said thirty-fourth degree of west longitude to the intersection of the same with the forty-first degree of north latitude; thence due east along said forty-first degree of north latitude to the intersection of the same with the thirty-second degree of longitude west from Washington; thence due south along said thirty-second degree of west longitude to the place of beginning. 1896

ARTICLE III

ORDINANCE

[Ordinance.]
[Religious toleration — Polygamy forbidden.]
[Right to public domain disclaimed — Taxation of lands — Exemption.]
[Territorial debts assumed.]
[Free nonsectarian schools.]

[Ordinance.]
The following ordinance shall be irrevocable without the consent of the United States and the people of this State: 1896

[Religious toleration — Polygamy forbidden.]
First: — Perfect toleration of religious sentiment is guaranteed. No inhabitant of this State shall ever be molested in person or property on account of his or her mode of religious worship; but polygamous or plural marriages are forever prohibited. 1896

[Right to public domain disclaimed — Taxation of lands — Exemption.]
Second: — The people inhabiting this State do affirm and declare that they forever disclaim all right and title to the unappropriated public lands lying within the boundaries hereof, and to all lands lying within said limits owned or held by any Indian or Indian tribes, and that until the title thereto shall have been extinguished by the United States, the same shall be and remain subject to the disposition of the United States, and said Indian lands shall remain under the absolute jurisdiction and control of the Congress of the United States. The lands belonging to citizens of the United States, residing without this State shall never be taxed at a higher rate than the lands belonging to residents of this State; but nothing in this ordinance shall preclude this state from taxing, as other lands are taxed, any lands owned or held by any Indian who has severed his tribal relations, and has obtained from the United States or from any person, by patent or other grant, a title thereto, save and except such lands as have been or may be granted to any Indian or Indians under any act of Congress, containing a provision exempting the lands thus granted from taxation, which last mentioned lands shall be exempt from taxation so long, and to such extent, as is or may be provided in the act of Congress granting the same. 1947

[Territorial debts assumed.]
Third: — All debts and liabilities of the Territory of Utah, incurred by authority of the Legislative Assembly thereof, are hereby assumed and shall be paid by this State. 1896

[Free nonsectarian schools.]
Fourth: — The Legislature shall make laws for the establishment and maintenance of a system of public schools, which shall be open to all the children of the State and be free from sectarian control. 1896

ARTICLE IV

ELECTIONS AND RIGHT OF SUFFRAGE

Section
1. [Equal political rights.]
2. [Qualifications to vote.]
3. [Voters — Immunity from arrest.]
4. [Voters — Immunity from militia duty.]
5. [Voters to be citizens of United States.]
6. [Mentally incompetent persons and certain criminals ineligible to vote.]
7. [Property qualification forbidden.]
8. [Ballot to be secret.]
9. [Elections, when held — Terms, when begin.]
10. [Oath of office.]

Section 1. [Equal political rights.]
The rights of citizens of the State of Utah to vote and hold office shall not be denied or abridged on account of sex. Both male and female citizens of this State shall enjoy equally all civil, political and religious rights and privileges. 1896

Sec. 2. [Qualifications to vote.]
Every citizen of the United States, eighteen years

on the list of those voted for as President, the House of Representatives shall choose immediately, by ballot, the President. But in choosing the President, the votes shall be taken by states, the representation from each state having one vote; a quorum for this purpose shall consist of a member or members from two-thirds of the states, and a majority of all the states shall be necessary to a choice. And if the House of Representatives shall not choose a President whenever the right of choice shall devolve upon them, before the fourth day of March next following, then the Vice-President shall act as President, as in the case of the death or other constitutional disability of the President.—The person having the greatest number of votes as Vice-President, shall be the Vice-President, if such number be a majority of the whole number of Electors appointed, and if no person have a majority, then from the two highest numbers on the list, the Senate shall choose the Vice-President; a quorum for the purpose shall consist of two-thirds of the whole number of Senators, and a majority of the whole number shall be necessary to a choice. But no person constitutionally ineligible to the office of President shall be eligible to that of Vice-President of the United States.

AMENDMENT XIII

Section
1. [Slavery prohibited.]
2. [Power to enforce amendment.]

Section 1.

Neither slavery nor involuntary servitude, except as a punishment for crime whereof the party shall have been duly convicted, shall exist within the United States, or any place subject to their jurisdiction.

Sec. 2. [Power to enforce amendment.]

Congress shall have power to enforce this article by appropriate legislation.

AMENDMENT XIV

Section
1. [Citizenship — Due process of law — Equal protection.]
2. [Representatives — Power to reduce appointment.]
3. [Disqualification to hold office.]
4. [Public debt not to be questioned — Debts of the Confederacy and claims not to be paid.]
5. [Power to enforce amendment.]

Section 1. [Citizenship — Due process of law — Equal protection.]

All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.

Sec. 2. [Representatives — Power to reduce appointment.]

Representatives shall be apportioned among the several States according to their respective numbers, counting the whole number of persons in each State, excluding Indians not taxed. But when the right to vote at any election for the choice of electors for President and Vice-President of the United States, Representatives in Congress, the Executive and Judicial Officers of a State, or the members of the Legislature thereof, is denied to any of the male inhabitants of such State, being twenty-one years of age, and citizens of the United States, or in any way abridged, except for participation in rebellion, or other crime, the basis of representation therein shall be reduced in the proportion which the number of such male citizens shall bear to the whole number of male citizens twenty-one years of age in such State.

Sec. 3. [Disqualification to hold office.]

No person shall be a Senator or Representative in Congress, or Elector of President and Vice President, or hold any office, civil or military, under the United States, or under any State, who, having previously taken an oath, as a member of Congress, or as an officer of the United States, or as a member of any State legislature, or as an executive or judicial officer of any State, to support the Constitution of the United States, shall have engaged in insurrection or rebellion against the same, or given aid or comfort to the enemies thereof. But Congress may by a vote of two-thirds of each House, remove such disability.

Sec. 4. [Public debt not to be questioned — Debts of the Confederacy and claims not to be paid.]

The validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned. But neither the United States nor any State shall assume or pay any debt or obligation incurred in aid of insurrection or rebellion against the United States, or any claim for the loss or emancipation of any slave; but all such debts, obligations, and claims shall be held illegal and void.

Sec. 5. [Power to enforce amendment.]

The Congress shall have power to enforce, by appropriate legislation, the provisions of this article.

AMENDMENT XV

Section
1. [Right of citizens to vote — Race or color not to disqualify.]
2. [Power to enforce amendment.]

Section 1. [Right of citizens to vote — Race or color not to disqualify.]

The right of citizens of the United States to vote shall not be denied or abridged by the United States or by any State on account of race, color, or previous condition of servitude.

Sec. 2. [Power to enforce amendment.]

The Congress shall have power to enforce this article by appropriate legislation.

AMENDMENT XVI

[Income tax.]

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

The full text of Utah Code Ann. § 59-5-3 (1986) [now codified at Utah Code Ann. § 59-2-201 (1988)] provides:

> Pipelines, power lines and plants, canals and irrigation works, bridges and ferries, and the property of car and transportation companies, when they are operated as a unit in more than one county, all property of public utilities whether operated within one county or more, all mines and mining claims, and the value of metalliferous mines based on ten times the annual net proceeds thereof as provided in Section 59-5-57, and all other mines and mining claims and other valuable deposits, including lands containing coal or hydrocarbons, nonmetalliferous minerals underlying land the surface of which is owned by a person other than the owner of such minerals, all machinery used in mining and all property or surface improvements upon or appurtenant to mines or mining claims and the value of any surface use made of nonmetalliferous mining claims or mining property for other than mining purposes; must be assessed by the State Tax Commission as hereinafter provided; except that property assessed by the unitary method, not necessary to the conduct and which does not contribute to the income of the business shall be assessed separately. On January 1, 1986, all methods of assessment used by the State Tax Commission not in statue shall be changed so as to increase assessment values by a factor of five. All taxable property not required by the Constitution or by law to be assessed by the State Tax Commission must be assessed by the county assessor of the several counties in which the same is situated. For the purposes of taxation all mills, reduction works, and smelters used exclusively for the purpose of reducing or smelting the ores from a mine or mining claim by the owner thereof shall be deemed to be appurtenant to such mine or mining claim though the same is not upon such mine or mining claim.

Utah Code Ann. § 59-5-4.5(1) (Supp. 1986) stated:

> When the county asse[s]or uses the comparable sales or cost appraisal method in valuing taxable property for assessment purposes, the assessor is required to recognize that various fees, services, closing costs, and other expenses related to the transaction lessen the acutal amount that may be received in the transaction. The county assessor shall, therefore, take 80% of the value based on comparable sales or cost appraisal of the property as its reasonable fair cash value for purposes of assessment.

§ 11503. Tax discrimination against rail transportation property

(a) In this section—

(1) "assessment" means valuation for a property tax levied by a taxing district.

(2) "assessment jurisdiction" means a geographical area in a State used in determining the assessed value of property for ad valorem taxation.

(3) "rail transportation property" means property, as defined by the Interstate Commerce Commission, owned or used by a rail carrier providing transportation subject to the jurisdiction of the Commission under subchapter I of chapter 105 of this title.

(4) "commercial and industrial property" means property, other than transportation property and land used primarily for agricultural purposes or timber growing, devoted to a commercial or industrial use and subject to a property tax levy.

(b) The following acts unreasonably burden and discriminate against interstate commerce, and a State, subdivision of a State, or authority acting for a State or subdivision of a State may not do any of them:

(1) assess rail transportation property at a value that has a higher ratio to the true market value of the rail transportation property than the ratio that the assessed value of other commercial and industrial property in the same assessment jurisdiction has to the true market value of the other commercial and industrial property.

(2) levy or collect a tax on an assessment that may not be made under clause (1) of this subsection.

(3) levy or collect an ad valorem property tax on rail transportation property at a tax rate that exceeds the tax rate applicable to commercial and industrial property in the same assessment jurisdiction.

(4) impose another tax that discriminates against a rail carrier providing transportation subject to the jurisdiction of the Commission under subchapter I of chapter 105 of this title.

ADDENDUM II

therefore, have equal "utility" at the moment, but the new property will produce the income for a longer time than the existing property. This difference in total utility creates a difference in the value of the existing property versus a new substitute property. This difference between new and existing property is depreciation.

From a theoretical viewpoint, a property should be worth the cost of a new substitute property less depreciation.

From a practical viewpoint, there are several methods for estimating both the cost new of the substitute property and the depreciation applicable to the existing property. The appraiser's task is to select the methods that result in an appraised value that approximates the market value of the property.

B. Types of Costs

The word "cost" can mean many different things, because there are several types of costs and different ways to measure them.

1. Historical Cost

Historical cost should be the cost of the property when first put into service (sometimes referred to as "first cost"). The cost should include all costs that were necessary to place the property in service, including materials, labor, interest on funds during construction, taxes and other overhead during construction, etc.

The original owner's accounting records are the best source of information for these costs, although there are potential problems in accounting records' costs. Even though regulatory agencies specify the accounting methods to be used by public utilities and railroads, errors can and do occur. Also, any cost based on "betterment" accounting has little meaning because the recorded cost does not measure the full cost of the item, only the estimated cost of the improvement or "betterment" of the item versus a replacement of the previously existing item.

Assuming the historical costs were recorded accurately, there remains a possibility that the cost has little to do with value because the costs were significantly higher or lower than they should have been, for any variety of reasons. Under the principle of substitution, the value of the property at the time it was first placed into service would be the typical value for a similar new property instead of the actual historical cost of the property.

Despite the potential problems mentioned above, historical cost is usually a valid starting point for a value indicator based on the cost approach. At the very least, the original purchaser of the property was willing to pay that cost for the property, which creates a reasonable assumption that the property was worth that much money at the time it was first placed into service.

2. <u>Original Cost</u>

Original cost is similar to historical cost to the extent it is the full, undepreciated cost that should be recorded in the owner's accounting records. Unlike historical cost, original cost includes pre-existing (purchased "used") property as well as new property (the used property is recorded at the price paid by the present owner).

The recorded cost should include all expenditures required to place the property in service, including the purchase price, freight-in if the property was moved, installation, renovation, etc. In reality, recorded costs of pre-existing property are often poor indicators of value because they are frequently only allocations of a mass purchase of assets, or are influenced by trade-ins, or are otherwise not representative typical value for similar property. Again, it can serve as a beginning point for a cost approach. The appraiser should, however, be aware of the limitations and weight the results accordingly.

3. Reproduction Cost New

Reproduction cost is an estimate of the cost to replace the existing property with a new property that is a duplicate, or virtually so, of the existing property. This cost can be obtained either from prices quoted by current vendors of the property or by applying an appropriate index to the original or historical cost of the property.

Current prices obtained from vendors usually provide the most accurate estimate of reproduction cost new. If not included in the quoted price, freight-in, installation, overhead during construction, etc., must be added.

Indexes are useful when time does not permit obtaining current prices and when current prices are not available because the item is no longer manufactured. The challenge is to find an index that is appropriate to the property being appraised instead of a generalized index that may or may not measure the change in cost of the property.

An index can also be applied to acquisition prices of used property. The result is not reproduction cost new, but it at least provides a measure of what a similar used property would cost today (disregarding depreciation).

The usefulness of reproduction cost new as a valid step in the appraisal process depends in part on the quality of the price quote or index that is used to estimate the cost and the amount of time elapsed since the property was new; it also depends on whether the property is suitable to today's business needs. The existing property may be superadequate for the probable use of the owner or a prospective purchaser, or the existing property may be obsolete in comparison to a modern replacement.

Another important factor to consider is whether the current reproduction cost has any bearing on the current and probable future earnings of the property. If the revenue levels are restricted to a historical cost basis, as in the case of regulated electric companies, local exchange telephone companies, etc., then reproduction cost is an unreliable value indicator because the owner cannot adjust revenues based on current property prices. Reproduction cost has not been a reliable value indicator for major railroads because accounting methods used by the railroad industry resulted in distorted statements of costs and returns. However, its reliability may change in the future as railroads implement new methods for recording costs and enter an era of deregulation.

4. Replacement Cost New

Replacement cost is the current cost to replace a property with a new property of equivalent utility. The price will differ from reproduction cost when technological advances have made the existing property obsolete or business conditions have changed and made the existing property somewhat unsuitable (for example, superadequate) for current and future use.

Replacement cost should reflect the current cost a knowledgeable person or company would pay if it is necessary to replace the existing property with a suitable new property. Any difference from reproduction cost could be considered as functional obsolescence not reflected by the reproduction cost estimate.

For practical purposes, it is difficult to estimate accurate replacement costs for larger companies because of the volume of property involved. In the case of rate base public utilities, the calculation is rarely worth the effort because current costs may have no bearing on the revenue potential of the property (due to regulation).

Replacement cost is an excellent starting point for estimating the value of a newer nonrate base company that has the regulatory freedom and economic ability to adjust revenues to current costs. Problems include the amount of work involved in obtaining accurate replacement cost data and the subjectivity of selecting replacement property. If the existing property will process 100 units per hour but the current needs are for only 50 units per hour, the logical choices for replacement is a new unit that processes 50 units per hour. Carried to the extreme, the total indicated replacement cost would be an idealistically low number which assumes that the system could be recreated with all its present features and absolutely no waste or error in acquiring the property.

It could be argued that the reproduction cost approach presumes that the existing property is, overall, so suitable that a prudent owner would reconstruct it exactly as it exists today, and the replacement cost approach presumes that the property can be replaced at the lowest possible cost. A realistic measure of cost new probably lies between the extremes.

5. Start-Up Costs, or "Organization"

Many kinds of property can be acquired and instantly placed in productive service. In the case of even a relatively small system property, however, it is virtually impossible to avoid substantial costs in the start-up stage (prior to the production of revenue) that cannot be identified with specific property items. Regulated public utilities are required to capitalize some of these costs (usually as "Organization") in a nondepreciable account. There is not likely any great uniformity as to how such costs are booked other than with regulated utilities; such costs are usually expensed in some manner on financial statements for nonregulated firms.

Prior to construction, start-up or organization costs are usually considered intangible and should not be included as an asset subject to property tax assessment. Once construction begins, the incurred costs are part of the physical property, even though they cannot be assigned to any specific part of the property.

Start-up costs become a part of the whole property, or system property, because the system cannot be reproduced or replaced without such costs. Regulatory agencies include "Organization" as a permanent part of rate base and the utility's customers are expected to pay an annual fair rate of return on those costs.

C. Depreciation

Depreciation is defined many different ways. To the accountant, depreciation is the accumulated allowance for recapturing the original cost of depreciable property as reflected on the company's accounting records. To the appraiser, depreciation is the accumulated loss of value due to all causes (physical, functional and economic), or the difference between "current cost" and current market value ("current cost" could be reproduction cost or replacement cost). 1/

1/ See AIREA Text, The Appraisal of Real Estate, 9th Edition, page 378, for definitions and discussions of depreciation.

1. Accounting Depreciation

Accounting-record depreciation is usually determined when the property is first acquired. The depreciation charged each year depends on the life assigned to the property (at the time of acquisition) and the depreciation method to be used (also usually assigned at the time of acquisition). Often, the company will show more than one set of annual and accumulated depreciation figures, for financial reporting purposes, for income tax purposes, or for any other suitable reason. The life and the depreciation method used may or may not be based on realistic assumptions. The key point is that book depreciation figures are intended as an orderly method to charge off or "match" costs of depreciable property against revenue; any resemblance to loss of value as measured by the market is largely coincidence except in the case of cost-rate-base utilities.

2. Appraisal Depreciation

To the appraiser, the life and depreciation method that should be used are reflections of the market's perceptions of the total life, the remaining life, and the difference in value between new and existing property. As the property ages, any resemblance between book depreciation and *market depreciation is mostly coincidence.*

Cost Approaches for Public Utilities and Railroads

The three preceding sections described several terms for "cost" and discussed basic principles of depreciation. This leads to the obvious conclusion that there are two critical steps in the cost approach: selection of the appropriate "cost" and selection of the appropriate depreciation (including any allowance for abnormal depreciation). This text cannot explore all the possible combinations of cost and depreciation but will discuss the more common methods and issues applicable to public utilities and railroads. The methods are: Historical Cost Less Depreciation, Reproduction Cost Less Depreciation, and Replacement Cost Less Depreciation.

Application of the cost methods requires the appraiser to specifically identify and account for all property to be included in or excluded from the cost indicators. For example, exclusions may be necessary for nonunitary and nontaxable properties while additions may be necessary for leased or other nonowned properties. The necessity for these kinds of adjustments will vary among states depending on administrative and legal definitions of the appraisal unit.

Direct additions or deletions of asset costs to the cost approaches has the advantage of simplicity. The disadvantage, however, is that corresponding adjustments must be made to the income, stock and debt, and sales comparison approaches, which tend to be much more complicated. Consequently, some appraisers prefer to make lump-sum value adjustments to the reconciled system value or to a state's portion of the system value. This is a straightforward procedure but has the disadvantage of requiring the appraiser to estimate the market value of the assets to be added or deducted. There is a theoretical question as to whether the individual value of such assets can appropriately be deducted from or added to a going concern value. Nevertheless, adjustments must be made. The appraiser should be aware that any procedure selected will have the imperfections of a value allocation.

E. Historical Cost Less Depreciation (HCLD)

Historical cost less depreciation, sometimes referred to as "net book value" or "rate base," is one of the more important indicators of value for closely regulated public utilities. The reason is because regulatory commissions regularly establish the aggregate cost of service for utilities at a revenue level that will provide for a "fair rate of return" on "rate base." Hence, it is logical that buyers and sellers would see the "base" for developing earning power as a significant factor for formulating investment decisions. The aggregate cost of service is a function of rate base, rate of return, and variable and fixed costs of operations; regulatory treatment of any of these categories can affect net earning power and therefore the reliability of the HCLD indicator.

Although HCLD is often called net book value or rate base, for property tax appraisal purposes it is the historical cost of the utility's taxable assets less the accumulated depreciation--calculated according to the method used by the Public Utilities Commission (PUC) or comparable agency--applicable to those assets. It differs from rate base because it excludes several items that may be in the PUC rate base and includes some items that are not in rate base. Common exclusions are items exempt from property tax, such as working cash, licensed vehicles, property located in federal enclaves, inventory, etc. Property not in rate base but normally included in HCLD (depending on state law) includes construction work-in-progress (including allowance for construction interest, or AFUDC), and leased property used for utility purposes. As explained in a subsequent section, HCLD should not be reduced by the current amount of deferred federal income taxes (DFIT), even though the PUC may deduct DFIT from net book cost for ratemaking purposes.

HCLD is a valid indicator of value if the utility is subject to rate regulation by a public utilities commission or comparable agency, the commission uses net book value as a base for establishing revenue requirements, and the commission actually does review and establish the utility's rates sufficiently often. If the commission for any reason does not review the utility's revenue requirements regularly, then HCLD has less validity because net earnings may rise above or fall below the level that would otherwise be permitted if reviewed. HCLD is an unreliable value indicator for public service properties not regulated on a cost rate base unless such properties are very new.

There are several issues concerning the calculation of HCLD and its value as an indicator. The next several pages discuss some of the more common issues.

1. <u>HCLD as a Limit of Value</u>

Two frequently expressed opinions are that (1) HCLD is the upper limit of value for a regulated utility because the regulatory agency will not permit the utility to retain earnings in excess of rate base times a fair (current market) rate of return, and (2) HCLD is the lower limit of value because the utility is "guaranteed" a fair rate of return as a matter of law. The fundamental appraisal assumption is that property is worth the price it will bring on the open market (under conditions defined by an overabundance of court rulings, statutes, and appraisal texts); no indicator can be presumed to establish an upper or lower limit of value. The great value of HCLD as an indicator for closely regulated utilities is that it tends to serve as an anchor; if current earnings are deficient, the market is likely to assume that the PUC will eventually grant adequate rate increases, and if current earnings are unreasonable, the PUC will eventually order reductions.

Regulatory agencies are supposed to monitor all utilities under their jurisdiction. They are required by law to allow the utilities an opportunity (not a guarantee) to recover prudent costs and earn a fair return on prudently invested funds, and are similarly required to protect ratepayers from excess earnings. It is only by coincidence, however, that a PUC-set rate base will equal market value. First, it is unlikely that any PUC (or other regulatory agency) has sufficient staff to monitor even the larger utilities as closely as the law suggests it should. Second, the method used by a PUC for the utilities' "return of capital" is usually set by law, with only minor variations permitted. Depreciable lives and rates are infrequently changed after the property has been placed in service, whereas the market's perception of the value of a property may be vastly different than net book cost, and the market's opinion of the method by which capital is recovered may be at odds with the method required by a PUC.

Thirdly, a PUC cannot react instantaneously to changes in market equity or yield rates. A PUC usually sets the "equity" rate at the conclusion of a rate hearing and is not likely to review it again for months or years. Even with frequent review, there is a tendency for rates to "lag" during periods of rapid rise or decline, since it is politically difficult for a PUC to authorize substantial rate increases when rates increase rapidly and the utility is unlikely to request lower revenues the moment market equity rates fall.

The most important point to bear in mind is that regulatory agencies are in the business of setting rates based on a complex set of legal, economic, and human factors. Those agencies do NOT determine or even estimate value any more than tax assessment agencies set rates. Therefore, the market's perception of value is likely to be at odds with rate base at any given time, but the power and obligation of the regulatory agency to adjust revenues periodically will certainly be considered by the market.

Although HCLD cannot be considered either a lower or upper limit of value, it would be fair to say that rate regulation provides a vague limit on how far market value will stray from HCLD. The risk of bankruptcy is nil and the opportunity for spectacular earnings growth is not available, particularly for larger utilities that are more likely to receive periodic attention by its regulatory agency.

2. Deferred Federal Income Taxes (DFIT)

Deferred Federal Income Taxes (DFIT), if entered on the books of a company, are classified as a liability or deferred credit. DFIT is an accounting entry that reflects a timing difference for reporting income and expenses. It is created when accelerated depreciation methods are used for income tax purposes and straight-line depreciation is used for financial statements, and it represents the accumulated difference between federal income taxes that would have been paid using straight-line depreciation and the taxes actually paid using accelerated depreciation. It is like an accrued liability because the tax benefits of accelerated depreciation will "reverse" after a few years and the taxes thereafter will be higher than they would under straight-line depreciation.

When DFIT are being generated, the amount of federal income tax not being paid results in increased cash flow because the PUC-allowed expenses include allowance for federal income taxes using straight-line depreciation instead of the taxes actually paid. This cash flow can be used for any purpose, including acquisition of revenue-producing property. Although utilities do not track the exact source of equity funds for property acquisition, there is no argument that substantial construction and other property acquisitions are made possible with DFIT.

PUC's deduct accumulated DFIT from rate base so that the utility customers will not have to pay the utility a profit on investments that were acquired with DFIT. The logic here is that a utility should not be able to recover a cost from its ratepayers that it never incurred. The HCLD indicator, however, should not be reduced by DFIT reserve because the property acquired with DFIT exists, is required for the operation, and is producing revenue. 2/ A utility's inability to earn an accounting "return on" investment acquired with DFIT is offset by its ability to collect revenue for a tax it does not yet owe. The regulatory practice of deducting DFIT from HCLD does not impair economic earnings. Management would not willingly exercise an income tax alternative that knowingly reduces the value of its firm. Furthermore, the DFIT relates to the present owner's income tax situation, which may not affect the potential for earnings in the hands of a purchaser of the assets.

3. Depreciation

Many companies keep two or more sets of accounting records, for various purposes. In the case of rate-base regulated utilities, one set of records will reflect depreciation (usually straight-line) allowed by the regulatory agency and used for ratemaking purposes; this is the relevant depreciation figure to use for the HCLD indicator.

2/ See Pacific Power and Light Company v. Department of Revenue, State of Oregon (OTC 2192; SC S34075) May, 1989 where the Supreme Court found that the Tax Court erred in deducting the DFIT reserve from the HCLD as a measure of obsolescence.

Many properties that are subject to central assessment are not closely regulated and do not maintain a depreciation account that would be acceptable for rate regulation purposes. In such cases, an HCLD calculation based on the assessee's book depreciation may be useful as a point of reference for establishing relationship between net book value and market value. The indicator, however, should be given no weight in the value reconciliation unless the property is new.

4. Obsolescence

Frequently, appraisers attempt to measure obsolescence that may be present in a utility property and deduct the obsolescence from HCLD. Such deductions are improper because of the nature of the HCLD indicator--it is an approximation of the rate base of the taxable property of a potential purchaser (with certain exceptions discussed previously). A deduction for obsolescence is just as inconsistent as adding value to HCLD because some of the utility's property has increased in value since it was acquired, or because the utility's earnings are extraordinarily high for some reason (such as lax regulatory oversight).

HCLD should be calculated according to the principles discussed above. If the property is not a rate base utility or if regulation is lax, the appraiser should weight the indicator accordingly in the value conclusion.

5. Blue Chip Method (Railroads)

Railroads are not regulated in the same manner as telephone companies or gas and electric utilities. Consequently, HCLD has little, if any, relationship to value for railroads, except by coincidence. However, one attempt to use HCLD as a value indicator is application of the "Blue Chip," "Super Blue Chip," or "Best of the Best," method. This method (or methods) involves comparing a mixture of various economic, quality, and efficiency factors among a representative group of railroads. In each category, the railroad with the "best" statistic is the standard, and the other railroads are supposed to have obsolescence present in some proportion to the difference between the subject's statistics and the best.

The result of the calculations is interesting but does not effectively measure the relationship between value and HCLD. The inherent assumption that a railroad's value cannot exceed HCLD is invalid.

The blue chip method may have some validity if used in conjunction with current cost concepts. Some appraisers contend that if the blue chip method actually measures depreciation, it must measure it in full and, therefore, should be deducted from reproduction or replacement costs rather than HCLD. Others believe it is too much a mixture of philosophies and factors to be used at all.

F. Reproduction and Replacement Cost Less Depreciation

Replacement cost less depreciation and reproduction cost less depreciation differ only in the estimate of undepreciated cost. Unfortunately, the same acronym (RCLD) is usually used for both approaches, although as the earlier discussions point out, the two approaches sometimes produce very different indicators of value. (Other interchangeable acronyms commonly used include RCLND for replacement/reproduction cost less normal depreciation and RCNLD for replacement/reproduction cost new less depreciation.)

Since the characteristics, advantages, and disadvantages of replacement and reproduction costs were discussed earlier in this chapter, this section will simply use the term RCLD to focus on the differences between RCLD and HCLD.

As the value indicator, RCLD presumes that the current earning power of a property is related to the cost of a new substitutive property. The difference in the present worth of future earnings between an existing property and a new substitute is due to the shorter remaining life of the existing property plus "normal" differences in operating efficiency and technological advances between old and new. RCLD is a poor indicator of value for closely regulated companies because their revenues are directly affected by net book value of existing property without regard to the current cost of substitute new property. If the company is not regulated or if regulation is lax, RCLD is the better indicator because the company will adjust its revenues to remain competitive while maximizing profits.

The quality of HCLD as an indicator of value is dependent on the degree of rate regulation, not age of the property. RCLD, however, is dependent both on the degree of regulation and on the age of the property. As the property gets older, the process of estimating reproduction or replacement cost new becomes more difficult, and the estimate of depreciation becomes more subjective. Capitalized earnings and sales comparison approaches are usually preferred over RCLD approaches for older properties, but for a relatively new property that has not yet developed its full earning potential, RCLD may be the most reliable indicator of value.

The preceding section discussed several issues concerning the calculation of HCLD. Most of the same issues are present in the calculation of RCLD, but there are differences that bear discussion.

1. <u>RCLD as a Limit of Value</u>

An argument is often made that RCLD, or at least RCN, is the upper limit of value because the property can be physically replaced for the RCN amount. This argument has some merit in the case of a small, ordinary property, where the entire property can be replaced very quickly, without any significant loss of future earnings. In the case of a complex system, various pieces of the system can be and are replaced routinely, but the entire system cannot be replaced without a lengthy, expensive delay.

Public service property is not just a haphazard collection of real estate and personal property, it is an assemblage of tangible and intangible property, management, labor force, customer base, accounting records, etc., working in harmony to produce a product or service for which the customers will return fair compensation. The whole system may be worth more or less than sum of its parts. The ability to estimate the current cost of certain parts of the system does not dictate the upper or lower limit of those parts' contribution to the value of the whole. RCLD is a useful indicator of value for nonrate base companies, but it has little relevance in appraisal theory as a limiting value. 3/

2. Depreciation

In the HCLD indicator, depreciation is the accumulated amortization of depreciable costs allowed by the appropriate ratemaking agency. For the RCLD indicator, depreciation is the difference in value between a new substitute property and the existing property. The difference between the two amounts may not be substantial when property is relatively new, but the difference is likely to be substantial for older property.

As stated earlier in this chapter, purchasers of property make assumptions or estimates regarding the total probable life and pattern of

3/ See ITT World Communications, Inc. v. Santa Clara County, 101 Cal.3d 246 (1980) where the court held that ignoring RCLD as an upper limit of value was not in violation of law and that capitalized earnings was proper even though in excess of RCLD.

operating income when they purchase a property. A property may have been expected to last 10 years when it was first purchased and may have been expected to decline in value at 10 percent per year. Four years later, conditions have changed regarding that particular property, and the remaining life could be considerably greater or less than six years, and the value of the property could be 70 or 80 percent of current replacement cost or could be nil. The appraiser's selection of economic life and depreciation method for existing property should be based on date-of-appraisal market evidence, not on assumptions that were made when the property was first acquired.

Ideally, depreciation should be the difference between the present value of the property's future earning potential versus the present value of the earning potential of a new substitute property. Realistically, appraisers usually employ standardized life estimates and depreciation tables--either developed from their own experience or recommended by their employer--and make adjustments where evidence indicates that the standardized estimates and tables are inappropriate.

3. Obsolescence

The section of HCLD recommends against making any deduction for obsolescence for specified reasons. In the case of RCLD, consideration of obsolescence is often the most difficult and important part of developing a valid RCLD indicator.

The most common adjustments to standard depreciation schedules are allowance for abnormal physical wear and tear and for economic and/or functional obsolescence. Such adjustments are challenging but necessary and practical when appraising individual properties. In the case of public service properties, adjustments for abnormal wear and tear are impractical due

WESTERN STATES ASSOCIATION OF TAX ADMINISTRATORS

REPORT

OF

COMMITTEE ON RAILROAD AND UTILITY VALUATION

1971

PART I

Introduction

The Committee on Railroad and Utility Valuations of the Western States Association of Tax Administrators has been studying for several years the matter of valuation. In some states centrally assessed properties refer to properties of railroads and utilities. In other states centrally assessed properties also refer to banks, mineral deposits, franchises, and other miscellaneous properties. When used in this report, centrally assessed properties refer to properties of railroads, utilities, pipe lines, airlines, water transportation companies, railroad car companies, etc. In most western states centrally assessed properties also include electric cooperatives and, in at least one state, there are included municipally owned electric systems. In this report therefore, centrally assessed companies generally refer to the various public service companies.

This report is the first phase of the Committee's findings and confines itself largely to valuation principles. Naturally, it is general in scope and *excerpts cannot be taken out of the text and claim made that they are absolutely valid in every valuation example.* The Committee does feel that certain broad attitudes can be documented and to the extent that the several states can work toward the principles stated herein, then the efforts of the Committee have been fruitful.

Another phase of the Committee's work will provide in the future suggested technical adjustments in computing indicators of value, again to seek uniformity of procedures as well as uniformity of attitudes toward the valuation problem.

During the five years that the Committee has been in existence, it has had cooperation and assistance not only from the several states through their tax administrators but also from the several industries through their tax representatives. The Committee had valuable assistance from the Graduate School of Business Administration of the University of California at Los Angeles which made possible the study of Dr. David K. Eiteman. The Committee was informed of attitudes and opinions of persons in the financial world through its Securities Prices Seminar. The Committee, too, was informed what management of industry felt was essential to proper valuations of their respective properties. Needless to say, there was no clear-cut obvious answer to the valuation problem. However, the cooperation and the contributions of ideas from all have been appreciated.

Market Value

Prior to discussing the several approaches to value (cost, income, and stock and debt), a few comments are appropriate on market value and on unit valuations. In the laws of most, if not all, states, there is a definition of value for property tax purposes. The descriptive words may be full cash value, actual cash value, true cash value, fair cash value, or market value. Without involving ourselves in the niceties of words, it is assumed that all of these values contemplate a value equivalent to a transaction where a willing buyer and a willing seller exist, where both parties are
2 knowledge~~able, where there~~ is no undue pressure or force to buy or sell, where reasonable time exists for exposure of the properties to the market and where negotiations are at arm's-length.

The natural comment from the critic or the intent student of central assessment is that since the properties sell so infrequently, there is never established a market value bench mark. This is true and it is also true of certain properties other than railroads and utilities. The mere fact that sales are lacking does not preclude the appraiser from attempting to estimate a value at the defined market value level. It becomes a real challenge to those in central assessment appraisals to find a theoretical market value. Because there are no sales, does not lead an appraiser to a salvage or scrap value concept. These would be appropriate only when salvage or scrapping was imminent. It does not mean valuing the properties under a different use unless a new use is in the offing. It does mean an estimate of a market value which a purchaser would pay contemplating a similar use of the property as of assessment date.

Unit Valuation

Closely akin to market value is the use of the unit appraisal technique. The unit appraisal means valuing the total properties as "one thing." In contrast, the summation appraisal is valuing individual items as fractional items and then adding together the value of all the fractions to reach the total. Centrally assessed properties are usually thoroughly integrated in operation and construction. The value of a length of copper wire in an electric system lies not in the fact that copper has a market as scrap metal

but that the wire is a part of a thoroughly complete and integrated
electric system. An item in the complex array of many property
items practically defies individual or segregated valuation. Segments
of the total property can be valued by allocation or apportionment
of the total unit value when required for statutory reasons even
though allocation violates the basic theory of unit valuation. As
the usual rule, however, no attempt is made to assign values in a
unit appraisal to individual items of property unless it is a legal
requirement. Standing apart, individual items of property possess
some type of liquidation value; arranged together as a team of
properties, the total property complex has a value invariably
greater than the sum of many liquidation values for individual
items. (For a discussion in greater detail, see the NATA Committee
on Unit Valuation Report (1954) or the Report of the Joint Interim
Committee on Assessment Practices to the California State Legislature
(1959) or "The Role of the States in Strengthening the Property 3
Tax." Volume 1, by Advisory Commission on Intergovernmental Relations,
Chapter 13 (June 1963).)

Cost Approach

Depending upon the circumstances, any type of cost may be appropriate for use as an approach to market value. Careful and thorough consideration must be exercised by the appraiser. Like any approach to value, the quality of the indicator must be studied and understood. All indicators of value are only as good as the quality of the ingredients.

In some publications and in some oral arguments, the position is taken that a certain approach is all wrong or it is all right. From a theory standpoint this could be so argued within limits. But by conceding that a given approach has weaknesses does not in itself conclude that some other approach provides valuation in perfection or of primary reliability. For example, the cost approach in
4 railroads has been stated by some authorities as being totally unacceptable. But upon examining the income approach, it is found that this is not an approach in perfection by any means though some profess it to be. Similarly, the stock and debt approach has its peculiarities so as to render it not the answer to the appraiser's dream. It becomes imperative then that the appraiser become a student of valuation so that he can distinguish strong and weak characteristics of an indicator of value rather than to issue a blanket blessing or condemnation, as the case may be, for a certain type of approach to value.

From a theoretical standpoint, present value is the present worth of *all* future benefits. If it is possible to measure those benefits in terms of dollars, to determine the duration of the stream of benefits and to establish accurately the discount rate, then the time-interest concept of money's value can convert the adopted conditions to present value. Also, from a theoretical standpoint, if sufficient valid market sales transpire in an appropriate length of time for the property in question or for truly comparable properties, then a market value can be ascertained directly. Again from a theoretical standpoint, if a market price can be confidently established for all the outstanding liabilities of a corporation, company, association or person, then this might measure the price of all the assets represented by such liabilities. And finally, from a theoretical standpoint, if the present day costs incurred by a prudent investor can be established for a new property (and depreciated for a used property), then this approach would strongly suggest present value.

This section of the report will be confined to the cost approach as much as possible except for reference or comparison purposes.

Indicators of Value

The cost approach to value is generally thought as a physical approach to valuation of property as distinguished from:

(a) Income approach,
(b) Market approach,
  (1) Stock and debt approach
  (2) Actual sales

Types of Cost

The cost approach deals with the property items themselves. Tne 5
types of cost include:

(a) Historical; cost when first put in service
(b) Original; cost to present owner
(c) Reproduction; cost today to reproduce in kind
(d) Replacement; cost today to replace present property with a functional equivalent

Four types of cost indicators are listed above. The appraiser can eliminate at the outset some of them and then others until he has left only those of acceptable application.

Historical and original costs are frequently synonymous but on occasion the technical difference is important. Where properties are recently new, these costs may be strongly indicative of market value, assuming a prudent investor is the owner and assuming no undue or extenuating circumstances were encountered in the construction or procurement of the properties. Where these types of costs are used by regulatory agencies, the costs may be a valid approach to value if the owner is earning adequately on the rate base, the market confirms that it is now, and probably will be, experiencing adequate earnings and the rate allowed is comparable to what is expected in the market. In the use of historical or original cost, the appraiser must recognize an adjustment to cost due to depreciation. From a regulatory viewpoint, depreciation is a book entry which reflects the amounts recaptured by the owner througn periodic diversion of revenues in an amortization type recovery over the estimated life of the property. Such a book depreciation may be inconsistent with depreciation as viewed by the appraiser, namely a loss in value due to all causes. The causes include physical deterioration, functional obsolescence and economic obsolescence. All these causes may not be appropriate as book deductions from historical cost or original cost yet they are basic considerations of the appraiser.

It is a common experience of appraisers of centrally assessed properties to hear the argument that the rate base (book cost less book depreciation) is market value for tax purposes. By coincidence they may be the same but basically they are different in theory. Rate base is a statistic, not a valuation, let alone a market valuation. If rate base were adopted as market value, it would be unmoved by inflation and depression, by adverse earnings, by varying costs of money and the whole market environment. Secondly, rate base is a reference point or datum plane to measure performanc
6 For illustration, if earnings are allowed at a certain level, it is not determined always by a percent times a rate base. In most cases a level of earnings is allowed and when that is related to a common denominator there results a ratio known as a rate of return. A rate base may be a very convenient reference point where if all conditions meet a certain standard, the base is value. Conditions that are usually encountered do not possess ideal characteristics; hence the appraiser must apply measurements of market attitudes to estimate market value. Thirdly, items includable in a rate base are not always taxable items; hence qualitatively they may be distinctly different.

Reproduction and replacement are the two cost approaches remaining. In some respects these may be synonomous. If replacement items were to be identical with the existing property, then replacement is reproduction. Secondly, if adequate allowance (functional obsolescence) is made as a deduction from reproduction cost new for oosolete characteristics of the existing property compared to a modern counterpart, then reproduction costs (adjusted) are similar to replacement costs. These types of costs basically provide for current costs as distinguished from antiquated costs. Further, these types of costs also contemplate only necessary and prudent investment as compared to costs of whatever nature found in historical or original costs.

Characteristics of Cost to Market Value

In the case of regulated property where the rate base is keyed to historical or original cost, reference was made not to a reliance on book depreciation for measurement of loss in value but more strongly to earnings performance and the market attitude to that performance. Finally, in the discussion of reproduction and replacement costs, those costs are appropriate only when measured by prudency. The prudent investor examines the market and concludes that a certain investment in a certain field will return to him certain benefits (earnings) in preference to other alternate investments. So it can be analyzed that the cost approach can be used if all the legitimate adjustments to costs (new) are made to result in an estimate of market value. No doubt, authors have sensed this or analyzed it similarly, that energies are wasted in seeking the correct cost approach and then theorizing all the adjustments that the given approach must have. They probably conclude to go to the earnings approach which has all the peculiarities and individual characteristics submerged in its three variables; namely, quantity of income, duration of stream of income, and the discount rate. As stated earlier, these three variables pose problems of their own.

If a cost figure can be adjusted realistically to reflect an approximate market value, it could be used in conjunction with other indicators of value to provide relative stability to a formulaic result. Too frequently, the emotional reaction to genuine short swings in earnings and stock prices causes the appraiser and tax representative to look to or advocate abrupt changes in valuation. If only earnings and stock and debt valuations are used, there will be strong possibilities of widely varying annual valuation results. Such changes from year-to-year (a) do not contribute to a sound tax economy at the local level; (b) cause unnecessary concern at conferences between administrator and taxpayer, and (c) are probably not realistic from a true valuation viewpoint. The use of earnings and stock and debt would produce widely varying results if the earnings being used were historical earnings as distinguished from probable future average annual operating income and if stock prices were not carefully analyzed prior to adopting them as primary indicators of value.

Another problem directly related to the use of the cost approach in the valuation of centrally assessed properties is the classification of property for local or central assessment. If a state has laws which provide for central assessment of a generous portion of the total properties even though *not actually used* in operations, there is a strong possibility that the earnings in the income approach are either inadequate or they may be totally missing from the earnings indicator. This is especially true in railroad assessments where idle lands may be centrally assessed but no future earnings (benefits) are represented in or imputed to the earnings indicator. Though the idle property has no earnings, it cannot be said that all such property has no value. Somewhat related to this are the properties that are expensed rather than capitalized. In these cases, both the earnings and cost indicators are understated and the use of a cost indicator, to some degree, with its imperfections may act as a compensating element in the valuation process.

The word "quality" nas been used and it refers, in this instance, to the credibility of the ingredients in an indicator of value. For example, if in the cost approach the inventory of items is inadequate, it will affect the quality and it will make no difference how well the items are priced or depreciated or how appropriate the cost approach is for the particular property. This matter of "quality" is found in the cost, income, stock and debt, and sales indicators. The "quality" can be good or poor and it must be recognized rather than using any one of the indicators blindly just because the particular indicator may have theoretical merit.

Salvage and Scrap Value

Two types of value not considered as costs but yet related to the physical approach as distinguished from income approach or economic approach and the sale or market approach, would be salvage and scrap value:

(a) Salvage value; value when destined for a secondary use
(b) Scrap value; value when destined for use as junk or for residual parts.

Salvage and scrap values can be investigated initially because they are applicable only when salvage or scrap operation is imminent. Where such a situation exists, the value approaching market value would be the net amount realized by the owner. For example, in the case of steel rail the value would not be the list price of salvage rail but less an allowance for the cost of removal. Depending upon the circumstances, the purchaser may quote a net price or the owner may market the residual property at his own expense to point of delivery. In the use of salvage and scrap values, reference is made to a price at which residual properties would be liquidated. Though spoken as a physical or cost approach, it is strongly referenced by market value.

Summary

The cost approach to value is not improper in itself. It may be difficult to make all the adjustments to it that are necessary. It may be that the cost approach is deferred in lieu of an approach that the appraiser feels is less difficult and more correct. The appraiser's task is to select the approach that is superior or to blend the approaches in a manner which he thinks is appropriate.

Income Approach

Analysis of Income

Though most centrally assessed companies have their accounting procedures prescribed by regulatory authorities, there is no assurance that the income so recorded is the income that is sought by the appraiser. The accounting procedures are no doubt proper for the purpose for which intended but they may be improper for valuation purposes. An understanding of the "quality" of income is essential so that reported income can be accepted as reported or so that it can be adjusted to accomplish the proper type of income. To illustrate, some companies may be using straight line depreciation and another using sinking fund depreciation; some companies may handle additions through maintenance accounting; some may treat
10 federal income tax deferrals and credits through deferral accounting and others by flow-through; some companies may make subsequent income and tax adjustments through these respective accounts and others may make all adjustments through the surplus account; some companies expense all capital items if they are less than a specified dollar amount; some companies provide for property retirement expense as an operating expense rather than a charge to salvage value; some companies do not segregate administrative costs to appropriate subsidiaries but charge them all to the parent corporation; some companies experience large capital gains or losses on disposal of properties suggesting improper depreciation rates during the reporting periods of the operation of the property; some properties produce benefits to the owner without showing a statistical income; some properties are idle or vacant and though centrally assessable would reflect no income in an income statement; some income has inadequate provisions for officers salaries and certain administrative overhead; some incomes have indifferent gross revenues bacause they subsidize the customer or another operating division of the owner; and there are probably other examples that deserve mention and attention of the appraiser.

Estimating Future Income

Another basic consideration that can be included in "quality" is the fact that the income to capitalize should represent the probable future average annual operating income to be derived from the properties that exist on the assessment date. This probably would preclude the use of averages of unadjusted past earnings in the case of either a growing or a shrinking property complex. In fact,

ADDEUNDUM III

7 The Cost Approach to Value: Cost Estimation

The cost approach to value, also known as the summation approach, provides a value indication that is the summation of the estimated land value and the depreciated cost of the building and other improvements. The cost approach to value is based upon the principle of substitution—that a rational, informed purchaser will pay no more for a property than the cost of acquiring an acceptable substitute with like utility, assuming that no costly delay will be encountered in making the substitution.

The primary use of the cost approach is to obtain a value estimate that can be compared with value estimates from the other two approaches. However, this is an ideal situation, for at times there are no sales data available. This is especially true for special-purpose properties, such as schools, hospitals, and churches. Assessors are particularly interested in the cost approach because, properly used, it is applicable to most classes of property and serves as a good foundation for uniformity and equality in assessments. The cost approach can be readily adapted to mass appraisal projects if current cost and depreciation schedules are market-oriented (see chap. 13).

The steps in the cost approach to value are as follows: (1) estimate site value, as if vacant; (2) estimate replacement cost new or reproduction cost new of the improvements; (3) estimate the amount of accrued depreciation; (4) subtract estimate of accrued depreciation from estiimated cost new; and (5) add estimated site value to estimate of depreciated replacement or reproduction cost. This chapter will concentrate on the estimation of replacement or reproduction cost new; chapter 8 will expand upon the estimation of accrued depreciation. In the treatment of cost estimation, consideration will be given to improvement analysis and methods of cost estimation.

Improvement Data

An inspection and a suitable description of the site improvements, including the building, should be the first step in the cost approach. The assessor, armed with a description and a value estimate of the site, usually has property record cards that assist in making a thorough inspection of the building. It is necessary to observe the quality, condition, and adequacy of each component and of the whole. Generally, the following elements should be rated as to quality, workmanship, and special physical characteristics.

- Overall quality
- Use type (residential, commercial, etc.)
- Construction (light, standard, better)
- Structure (foundation and framing)
- Exterior
- Roof (type, pitch, cover, gutters, and eaves)
- Wiring and fixtures (type and grade)
- Windows (type, screens, storm windows)
- Plumbing (type and grade)
- Heating and air conditioning (type and capacity)
- Special features
- Equipment
- Room and finish detail (floors, walks, and trim)
- Bath details (number, type, and grade)

- Construction record (year built, effective age, remaining *economic life*)
- Miscellaneous improvements

In addition to recording and rating the above features, the assessor should make a sketch of the building dimensions and square-foot and/or cubic-foot areas.

After rating and recording the quality of the individual components, the assessor must be concerned with functional utility. Functional utility is the overall usefulness and desirability of a property; the ultimate criterion is whether the improvement efficiently satisfies the wants and needs of the market. Elements to be considered in determining functional utility are architecture and appearance, layout, systems, and equipment. Poor or inappropriate architecture, wasteful floor plans, bad natural lighting, inappropriate room sizes, and inadequate heating or cooling capacity should be judged by the assessor as to deficiency in functional utility.

Cost Estimation

Cost estimation is the process by which the replacement cost or reproduction cost of improvements is obtained The process begins after all the pertinent physical data regarding the improvements have been collected.

Elements of Cost

Cost consists of all the direct labor and materials and indirect expenditures required to complete the construction of a structure. From the viewpoint of the builder or developer, cost includes all the components of expense incurred in the manufacture of the building. The builder or developer intends to recapture all these costs, including

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The Cost Approach

The cost approach historically has been known as the summation approach — that is, the sum of site (land) value plus improvement value equals property value — but that term is rarely used anymore. The concept of the cost approach is based on the principle of substitution. It states that no rational person will pay more for an existing house than the amount for which he or she can obtain, by purchase of a site and construction, without undue delay, of a house of equal desirability and utility.

The philosophy in the cost approach to market value is unique compared to the other two approaches. The approach uses the sales of comparable sites to develop a market value estimate of the site as if unimproved, to which is added a market value estimate of the improvements based on "cost new" less any and all depreciation (loss in value). The procedure for the development of market value of the improvements is the conversion of "cost to construct" figures to market value figures. Cost is not necessarily or automatically the equivalent of market value. The process of making such a conversion requires care, caution and great skill.

A separate valuation of the improvements is needed for a variety of reasons, and the cost approach is one of the ways to obtain such valuation estimates. These reasons include tax purposes (where ad valorem tax laws dictate this separation in value), accounting (where it is desired to reflect the depreciation of buildings) and to obtain the value of the land by the land residual method. The cost approach is especially useful to estimate the value of special purpose properties where there is no market.